RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 • REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION
POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

November 6, 1985 LETTER 925

Oct. 25 DJIA 1356.52; PTI 1918; A-D Ratio -15.33
Nov. 1 DJIA 1390.25; PTI 1940; A-D Ratio -14.68

THE PICTURE: People often ask me, "Russell, why don't you write more about market sentiment, about percentage of advisories bullish and consumer confidence and that sort of thing?" And I answer, "I don't care what people say they're going to do, I'm interested in what they're doing and how they are actually spending their money."

And that's why the items that fascinate me most in this business, the area that I spend most time on -- is price action. All the ideas, the plans, the bullishness, the bearishness, the projections and the theories are boiled down and concentrated into price action. I don't care about the projection of American car manufacturers, the plans of Detroit designers or the intricacies of auto economics. You know what attracted my attention last week? It was the new low for the year in General Motors. I know what that low means. It means that investors now see less chance for profits at the US's largest auto manufacturer than they have at any time over the last year. To me, that's meaningful. As far as the projections of auto sales are concerned, it's a question of which publication you read.

I've been around this business for quite a while, but I don't think I can remember a time when there were more crosscurrents, divergences and discrepancies on Wall Street. Just for the record, I'll recite some of them now. (1) Bearish -- the D-J Transportation Average has been weak. (2) Bearish -- the advance-decline ratio, a proxy for all the stocks on the NYSE, has been pathetically weak on the latest rally. (3) The A-D line for the 30 Dow Industrials (see chart this page) has been very weak, and that's bearish. (4) Bearish -- new lows in bellwether General Motors. (5) Bearish -- the momentum or year-to-year change in the S&P 500 has been very poor on the most recent rise in the 500. Now for some bullish items: (1) The odd-lotters have been shorting their heads off over the last few weeks. These guys (at least near-term) are seldom right. (2) The NYSE Financial Index has looked considerably better over the past month. This Index is extremely important, as it includes all finance-connected stocks on the Big Board from banks and S&Ls to brokers and small loan companies. (3) The D-J Industrial Average is still far above its critical level of 1297.94. You won't have a market collapse while the Dow holds up. (4) The bond market has been exploding. The stock market and the economy like nothing better than a strong bond market. (5) The foreign markets are acting exceptionally well. Since primary trends tend to be international in scope, it's a plus when the foreign markets are doing well. Of 11 foreign markets that I follow, the majority are acting well with Germany, Hong Kong, Switzerland, Australia, Norway, Denmark, Britain, Japan and Sweden all at or near their highs for 1985.

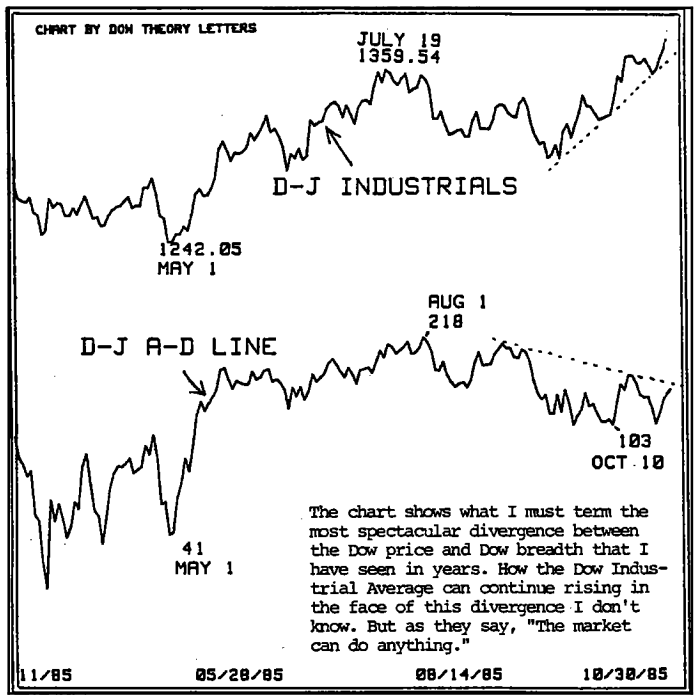
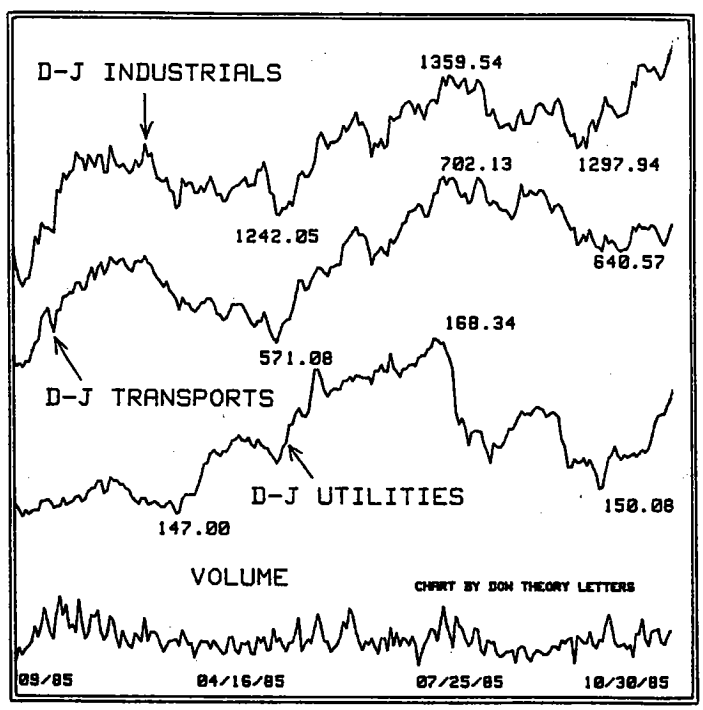
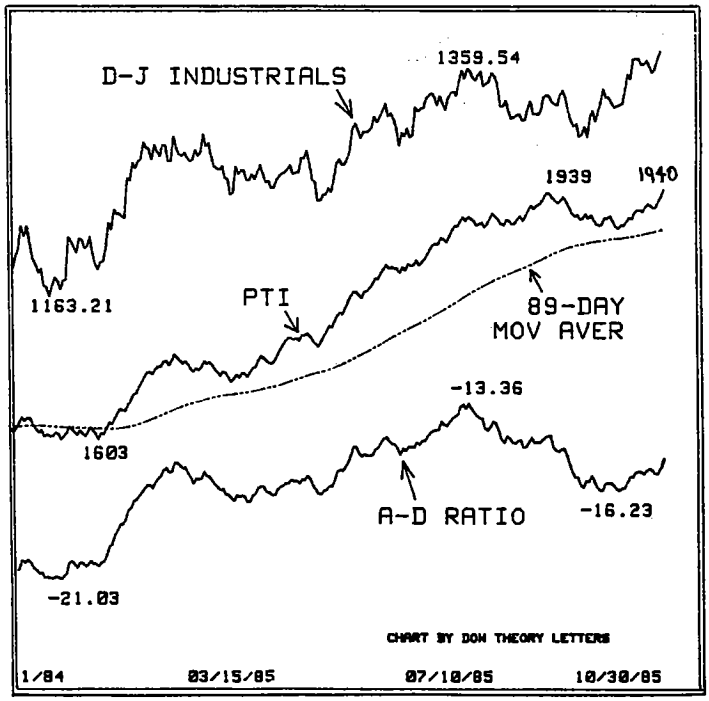


CHART BY DOW THEORY LETTERS
JULY 19
1359.54
D-J INDUSTRIALS
1242.05
MAY 1
AUG 1
218
D-J A-D LINE
103
OCT 10
41
MAY 1
The chart shows what I must term the most spectacular divergence between the Dow price and Dow breadth that I have seen in years. How the Dow Industrial Average can continue rising in the face of this divergence I don't know. But as they say, "The market can do anything."
11/85
05/28/85
08/14/85
10/30/85





Now I could go on and on with my list of the various pluses and minuses. But I'm not going to. The reason is that they may be interesting, but they are not going to help us in our investing. What will help us? As far as I'm concerned, the item that will help us is the time-honored concept which states that "The trend is taken to remain in force until PROVED otherwise." The last confirmed trend of this market was bullish. The trend was confirmed as bullish by both Dow Theory and my PTI. So until those signals are countermanded, I suggest we accept the thesis that this is a bull market. There has been no proof that it is anything else.

What would prove to me that the bears were in command -- that a bear market was in force? (1) I would want to see a Dow Theory bear signal. That would entail the D-J Industrial Average breaking below its September low of 1297.94 confirmed with a Transport close below 640.57. (2) The other bearish signal would be a break by my Primary Trend Index below its 89-day moving average.

So there are the two signals which will ultimately part us from our stock portfolios. And when you think about it, we are very fortunate. We can read bearish news from now until kingdom come, but we depend on market action itself to ring the bearish bell. And a clear, unhedged, decisive bell it is -- either the D-J Averages render a Dow Theory bear signal or the PTI breaks below its 89-day moving average.

Question: Russell, last month you sent out two special warning reports regarding your PTI. Yet the PTI never broke down; it's still holding well above its 89-day moving average. How do you feel about these warnings now?

Answer: I've told my subscribers that they don't run the stock market for Richard Russell. I don't send warning Letters out lightly, not with postage at 22¢ a Letter and other mailing costs sky-high. I told my readers exactly what I saw, namely, that the PTI was in a potential top formation, and that if it broke down below the 89-day moving average that market was in trouble. I also said that when these tops had appeared in the past, they were usually the forerunners of trouble. So far, the only trouble has been in the sub-standard action of the Transports and the major composite averages, but even there there has been no breakdown.

You can call those warning reports "insurance" against a surprise on the downside. When you buy life insurance and you stay alive year after year, you don't complain. It's the same thing when you buy insurance in the market. I consider those two October warning Letters to be a form of financial insurance.

INVESTMENT POSITION: The bull stays in the box, and he'll reside there until one or both of the previously described bear signals appear. The technical divergences and non-confirmations are many in this market, but as I've said so many times before, we give the prevailing trend (which today means the bull trend) every benefit of the doubt. In my opinion, the great bond market action and the massive odd lot shorting have staved off any corrective action so far. Whether the strength can continue remains to be seen (the market is now over-bought as well).

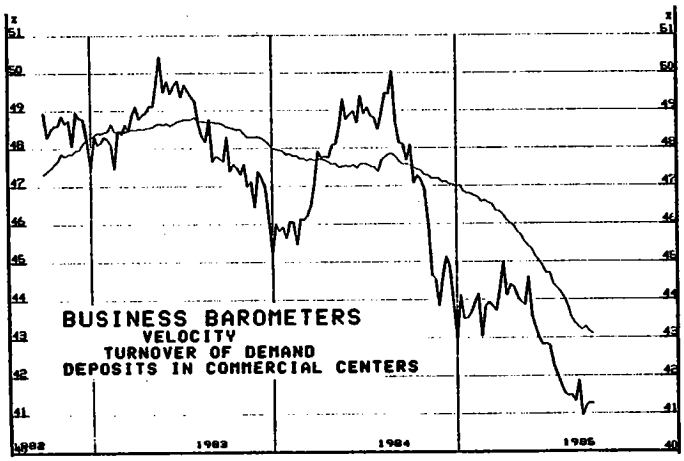
Stocks: For your interest, the following are the strongest stock groups on any of the exchanges during 1985 so far: Agricultural operation (up 45%); container (paper or plastic) (up 41%);food-confectionary (up 45%; insurance-brokers (up 44%); pollution controls (up 41%); retail-apparel (up 51%); water utilities (up 41%), and vending machines (up 73%). Of these groups (which were picked out of the 196 different groups), the following are still strong: containers; food-confectionary; insurance-brokers; water utilities, and vending machines.

I have just reviewed the technical position of the 30 Dow Industrial stocks (on the basis of relative strength to the market and on the basis of position in relation to their own moving averages). Of the 30 stocks, only eight are still technically bullish and two (Amer. Express and MacDonalds) are questionable. The eight still-bullish stocks are DuPont, Exxon, Merck, Owens-Illinois, Procter & Gamble, Union Carbide, Westinghouse, Woolworth. Of note: on October 25 GM broke to a new low for the year -- never a good omen. Dow stocks whose looks I particularly don't like are Amer. Tel., Kodak, Harvester, Int. Paper.

CRITICAL CHARTS: I've shown this chart (courtesy of Mansfield) before, but here goes again. This is one of the most critical and fundamental studies in economics. Here we see velocity or the turnover of demand deposits at the commercial banks. In a phrase, what we are looking at here is business activity. And following the double tops of 1983 and 1984, velocity turned down. It is dropping into new low territory now.

Who cares? Well, the Fed cares, for one. And this drop-off in velocity is the main reason why the Fed has been pumping up the money supply. The Fed's been pumping because it wants to offset the deflationary forces of sinking velocity.

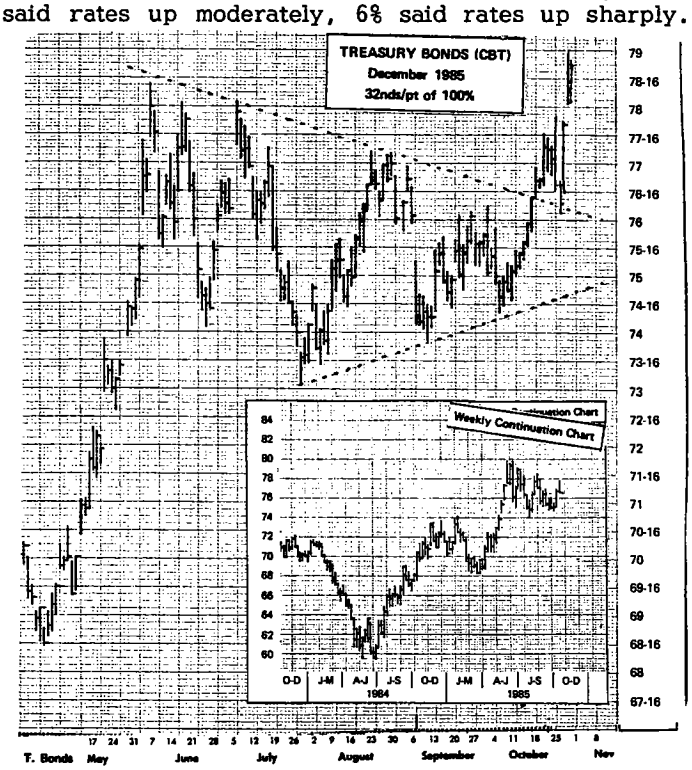
Mr. Volcker knows that this is not just another downward blip on the velocity chart. No, this is one



of the biggest declines in money velocity since the 1940s. Volcker knows that if the velocity line continues to decline, the US is going to face recession -- and worse, depression. Twenty or 10 years ago this kind of drop in velocity would have been serious, but it could have been weathered. But with $7 trillion in assorted debts now laced through the US economy, a major and persistent drop in money turnover can lead to collapse.

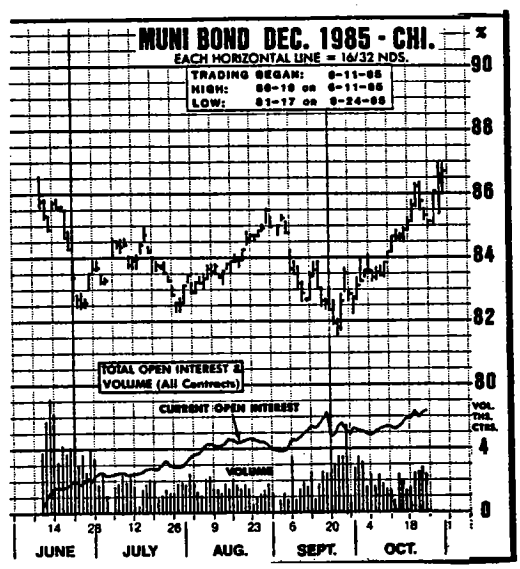
There are two schools among those who understand velocity. One school believes that velocity will soon turn up, that the economy will be rejuvenated, and in due time everything will turn up roses. The other school believes that what we are seeing on this chart is a reflection of a topping out of the great 55-year Kondratieff wave. This school is of the opinion that velocity is going to continue to fall, that the US is on the edge of a recession (depression), and that nothing the Fed or anyone else can do -- is going to turn velocity around. We'll monitor this study carefully.

Bonds and rates: US News & World Report recently polled 49 leading economists on the trend of long-term bond rates over the first six months of 1986. Of those polled, 20% said they expected little change, 59% said rates up moderately, 6% said rates up sharply.



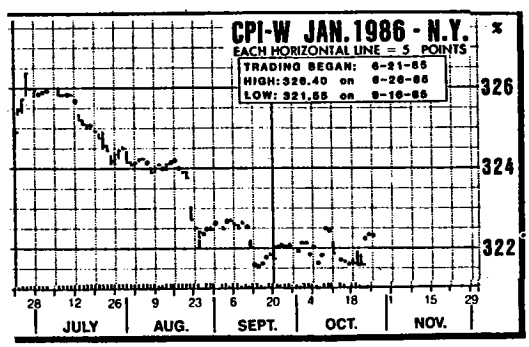
Only 14% said rates down moderately or sharply. That means 65% of the experts are looking for higher rates and only 14% for lower rates. Contrary opinion, anyone?

The daily chart of the December T-bonds (courtesy of Dunn & Hargitt) shows the T-bond in a massive triangle. Last week the bonds finally broke out of the triangle on the upside. The new high in bonds could hardly have come as a shock to my subscribers. I have been recommending bonds (particularly muni bonds) since the beginning of the rise during the summer of '84.



This Commodity Research Bureau chart of the muni bonds (Dec. contract) tells the same bullish story -- a breakout to new highs. Those who bought bonds in mid-1984 should now be showing a fat capital gains profit of roughly 30% plus another 12% in locked-in interest for a total of about 42%. Not bad for a relatively safe investment. Even those who bought bonds at last spring's lows should now show a capital gains profit of about 16% plus another 11% in income for a total of roughly 27%. Of course, if you bought munis instead of T-bonds, all the income part of the gain would be tax-free. To my mind, bonds were the great play of 1984-85. Unless, of course, you are thinking about General Foods. But I recommended that stock too -- numerous times.

I seldom buy commodity contracts. I lack raw nerve, and I admit it. Also, I invest rather than speculate, and investments bring in income. If it doesn't have income (with the exception of a house and gold), I won't buy it. But that doesn't mean that I don't follow the commodity action with intense interest because I do.

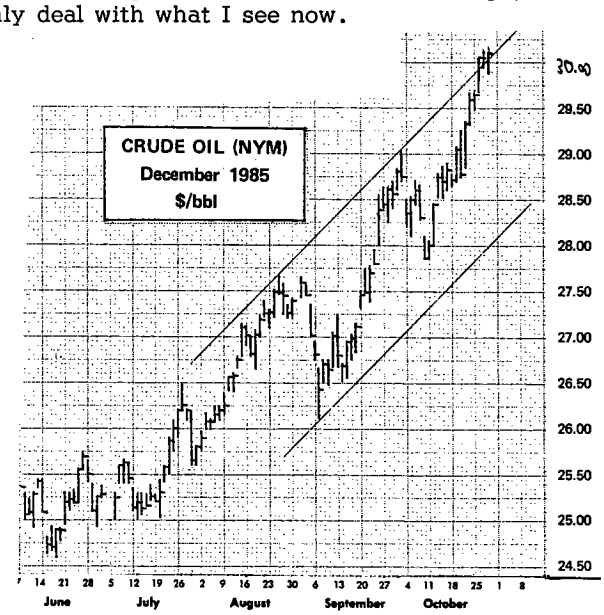


One of the little-known contracts that I follow is a new one, and it is charted by CRB. Here it is, the Consumers Price Index contract. This contract shows us what speculators believe will be the course of inflation. It's an interesting contract because here

speculators are betting on inflation or deflation with their cash rather than their mouths. What we see here is a downtrend in the CPI contract, and that tells me that the smart boys are betting that inflation is minimal next January. Furthermore, note that they've been steadily lowering their inflation expectations since last July when this contract first appeared.

The inflation picture is really extraordinary when you think about it. Here we have the US government running $200 billion deficits and there's no inflation. If we had seen these kinds of deficits 10 years ago, people would have been screaming about rampant inflation and gold would have been surging. Today, there's no sign of inflation, the precious metals are dormant, and commodity prices are still scraping the bottom. Last week the international tin supports were removed and tin caved in. Another widely-used metal, aluminum, hit new lows below 44 last week, and it may interest you to know that aluminum was over 60 as recently as last December (aluminum is down 25% in price over the last year).

All this is telling me that in the economic background there is a specter, and that specter is deflation. In fact, as I noted, the forces of deflation and world debt are now so strong that a $200 billion US deficit cannot even push up the price of gold. On top of that, the weaker dollar has not, so far, produced any inflation in prices. All that could change, but I can only deal with what I see now.



Another "shocking" area, and one that I have been pointing to for months is oil. Despite what everybody was fantasizing about, the actual PRICE of oil has been rising, as you can see on this Dunn & Hargitt chart. The oil rise was particularly amusing, because for months leading economists (who evidently couldn't read charts) kept talking about "the falling oil prices". It was a case of mass hypnotism. At any rate, those who bought the oil stocks (and I recommended Exxon and Petroleum & Resources Preferred) have not done badly. There's no more pleasant and profitable ride than on an item that is going up when everybody insists that the item "should be going down". In fact, with oil it was even more comical -- people actually believed it was going down when it was rising week after week.

MAKING MONEY: Every seasoned investor has his own way of making (or trying to make) money in the market. Naturally, I have my own way. It's a conservative way, and it's tailored to fit my own particular psyche and personality. When I (foolishly) attempt another technique, I may make a little or lose a little, but basically I am not successful. At any rate, here is my method.

In order to make big money, it's axiomatic that one must assume a sizable investment position. Now I have two requirements which must be met before I will take a large position.

(1) The item (or items) I buy must represent outstanding value (usually based on yield), and they must be inherently safe enough so that I am not going to stay up nights if they drop 5% or 10%. That means that I am never going to take a big position in BBB-rated bonds or a package of speculative O-T-C stocks. True, BBB bonds and selected O-T-C stocks may do very well, but I am not willing (i.e., I'm afraid) to take an initial big position in this kind of merchandise.

(2) My second requirement is that my position must go AGAINST the generally perceived investment background. In other words, I must be buying a good, safe value when such a position seems totally contrary to the prevailing investment opinion.

I took my first BIG position in late-1958 and early-1959, and it was in stocks. At that time I went heavily on margin (which I have never done since), but I was totally convinced that the market was headed up (I started Dow Theory Letters on the strength of that conviction). I was on margin, and I was buying into a market that everyone "hated". But it was a market of high yields and great values, and it was a market that simply would not stop climbing -- to the consternation of both Wall Street and the public. The 1957-60 rise gave me some of the best profits I have ever made in the markets.

The second best move I have made was during 1974, when I bought a collection of good grade stocks off the extreme bottom. Many of those stocks doubled within six months of purchase. The stocks were bought at a time when people were saying that the Dow "would be cut in half by 1975". The pessimists could not have been more mistaken.

My recent best position was taken in bonds during early 1984, at which time (see February 1984 Letters) Treasury bonds were yielding better than 12%. I wrote at the time that at 12% in safe Treasuries you could compound and get almost 40% on your original money within three years. The risk/reward equation in bonds at that time seemed irresistible to me. I began building up my bond position, and I urged subscribers to do the same.

The beauty of the 1984 bond position was that one could assume a large position in an extremely safe investment and sit with that investment. If the bonds declined, you were nevertheless receiving a high rate of return, a return that would bail you out quickly based simply on the high rate of interest. On the other hand, if the bonds rallied you would have a double profit in that you would receive 12% plus whatever appreciation was garnered by the bonds. As it happened, the year 1984 saw a huge rise in the bonds and the total rate of return (interest plus appreciation) hit 40% in some cases.

I also recommended muni bonds at that time (and ever since) and here one received tax-free interest plus appreciation. Thus, the bond play of 1984 was one

that I was willing to go into -- with the majority of my capital.

"Fine," you retort, "but that's all history. What do we do next?" And my answer at this time is simply, "I don't know." Great market plays don't come around every week or even every year. But when they do one has to measure the risks and the relative safety, one has to decide whether the time is right -- and then you have to make the move.

At this time I continue to believe that the best values are offered by muni bonds, but obviously the bonds are nowhere as cheap as they were in 1984, and consequently I cannot recommend a huge position in them. Roughly 31% of the stock market is undervalued (figures from Investment Quality Trends of La Jolla) so it is hard to become terribly enthusiastic over the stock market. The precious metals are still backing and filling and the opportunities here (at this time) appear to be limited.

So that leaves me with the feeling that a diversified position is best, some bonds, some stocks, plenty of cash and some gold coins. I note that a few sophisticated fund managers are sitting with 35% to 50% in cash. I wonder -- could cash be the sleeper of 1985-86?

NOTES & QUOTES: Bonds: I've been saying all along that I personally don't buy insured muni bonds. The reason is that I want any bond I buy to stand on its own. If a bond has to be insured to get a high rating, I don't want it. Besides, I've asked, who insures the insurers?

Ahem, now it starts. On October 24, it was announced that $6 billion in muni bonds face downgrading because Standard & Poor's has placed Crum & Foster on its Creditwatch. Crum & Foster is the parent company of Industrial Indemnity, the insurer of some 275 muni issues. This comment was offered by the WSJ:

> The potential S&P action bolsters some analysts' belief that, in the midst of a growing municipal bond insurance industry, investors must research not only the underlying securities but the insurer as well.
>
> Howard Sitzer, director of Thomson McKinnon Securities Inc.'s municipal research department, says a downgrading of Industrial Indemnity would be."a very significant development" that could "change the whole picture of bond insurance.

* *

Shame: The US budget deficit for 1984-85 came in at $211 billion, a new record. Dividing by the working days of the year, this comes in at approximately $811 million a day of deficits for the Treasury. To put it in perspective. if you possessed an amount equal to one day of US deficit, you'd immediately qualify for the top end of the Forbes 400, the list of the 400 richest people in America.

* *

Thank the Yanks Dept.: Cancer has been the leading killer in Japan with cerebral hemorrhages and brain disorders second. The brain disorders came (my theory) because the repressed and high-pressure Japanese would literally blow their tops. But over the past 15 years American-type diet and fast food has come to Japan. So what has happened? The No. 2 killer in Japan is now heart disease. The great Japanese staple diet of fish and vegetables has given way to burgers, fats, Western yummies -- and heart attacks!

* *

Well, 22 states now have lotteries, and the winners will probably be surprised to see what is left after paying their taxes. Of the 22 states, only two (Connecticut and Washington) have no state taxes. But California does not tax winnings in its new lottery. The IRS will take almost half on a million dollar winning prize. But most of the states will not pay a lump sum; rather they pay you so much a year. The state buys an annuity and pays you so much a year for 20 years, thus cutting down the real value of the winnings considerably. Actually, winners would be far better off getting a lump sum prize, putting the after-tax winnings into muni bonds, and then getting tax-free income plus the return of their money when the bonds mature. But the states aren't being that kind. When you win in the lottery, you get after-tax prize money, which is a lot better than nothing, but a lot less than a lump sum.

* *

What is it with the Jews? Four Jews changed the fundamental thinking of the world. These four were Jesus, Freud, Marx and Einstein. To bring this extraordinary phenomenon up to date, 30% of America's Nobel laureates have been Jewish. On top of that 23% of the 1984 Forbes 400 (wealthiest Americans) were Jewish. Expert Charles Kadushin compiled a list of America's 21 most eminent intellectuals and 15 on the list were Jews. All this with a Jewish population in America around 3%.

What does it mean? My theory is that the Jews survived by being bright and educated or being able to make money. A remarkable fact is that 80% of Jewish children in the US go to college. Thousands of years of persecution have forced the Jews to learn how to survive. It was a case of excel or perish.

How about the remarkable record of the blacks in sports? Of the top 1985 draft picks in both basketball and football, over 80% were black. Why? Because one of the few areas where blacks can excel without prejudice is sports. And their ethnic background has not, in the past, emphasized education as the means of survival.

*

Is Russell a low-life, an anti-intellectual? Probably. At any rate among things I'm addicted to are: (1) cop movies; (2) USA Today, along with about eight other daily newspapers; (3) Larry King's all-night radio show (I love that guy); (4) Chinese food, no matter how hot as long as it isn't oily; (5) Motorcycles, although I finally stopped riding after 25 years; (6) Magazines, and if there's one I don't subscribe to I don't know what it is. I read 'em all from the Economist to Soldier of Fortune, from Life and Time to Newsweek, New Yorker, New York, Crain's New York, "W", Playboy, Interview, Gourmet, Fortune, Business Week, Barron's, Forbes and on and on and on.

* *

The great "house cleaning" is on at American corporations, and the cleaning entails laying off white collar people and management executives. The reason: the desire to boost profits. Roughly 90% of America's largest corporations are now in what they call "management realignment". Examples: AT&T Information Systems is laying off 24,000 people, 30% of them in management. Ford plans to slice its salaried force by 20% or 10,000 people by 1990. Union Carbide will lay off 4,000 white collars, DuPont took 12,000 early retirements, CBS is trying to retire 2,000. On Oct. 15 it was announced that Time Inc. wants to reduce its staff to the tune of $75 million. On the same day TWA said it will cut management jobs by 15% to save near $100 million annually.

Last week Doug Casey (he writes "The Crisis Report") dropped in to see us. Doug has been living in Hong Kong for the past six months and had a lot of fascinating things to say about Hong Kong. ("They have so many shops selling so much merchandise that I don't see how they all survive -- but they do.") At any rate, we talked about other services, what we read and why. I think Doug was a bit surprised at how many different newspapers and advisory services I read.

Actually I have my own way of reading each publication. Some I peruse, some I read with care, some I can only read in the bathtub at night. And speaking of reading, I got a jolt when I read this piece from Howard Ruff's "Financial Success Report" (800-654-4455). I thought I was the only conservative who hates President Reagan's waffling and pussyfooting on many critical issues:

> **President Reagan is again displaying his disturbing tendency to make an assessment that he is going to lose a political fight, and then jumping in front of his opposition. If he can't beat 'em, he joins 'em.**
>
> **He has unilaterally banned the importation of Krugerrands, effective October 11, without waiting to see if GATT (General Agreement on Tariffs and Trade) will approve it. The President has again surrendered an important principle to avoid political defeat.**
>
> **Just once I'd like to see him take a stand on a principle he believes in, even if he is sure to lose. You know he believes that sanctions against South Africa are wrong and will only make a peaceful solution in South Africa more difficult.**
>
> **I'd like to see him stand tall and veto a bad bill, even if he knows it would be overridden. I'm almost getting nostalgic over GERALD FORD. He used the veto over and over again. I can't remember Reagan's last veto. Just once I'd like to see him, like DON QUIXOTE, "be willing to march into Hell for a Heavenly cause."**

* *

Last week a subscriber asked, "Russell, you say that the forces of world over-production and deflation are very strong. Then why do you buy gold?" I told him, "About 20 years ago there was a cartoon in the old Esquire magazine. It showed two pompous gentlemen sitting in easy chairs in an obviously very luxurious men's club. One turned to the other and said, 'I just sent $1,000 to the NAACP -- just in case.' " I buy gold for the same reason -- just in case.

GOLD: I watch LA's channel 22 for most of each morning, although I often switch to the excellent Financial News Network. What amazes me is the number of gold, silver, precious metal and hard money ads which appear on these stations. How come, with the metals doing little or nothing? Frankly, I can't figure it, unless (1) the public is still living in 1979-80, believing that a new gold boom is coming, or (2) the public in its mysterious unconscious intuits that all this monetary inflation must and will lead to a new boom in precious metals. As I say, I'm mystified.

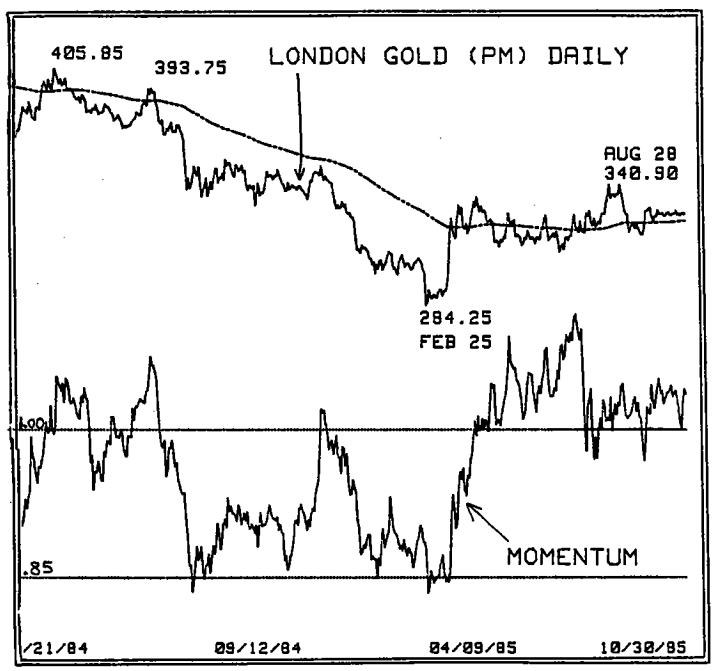
As you read this Letter we will have just left the big New Orleans seminar put on by the National Committee for Monetary Reform (that is, if New Orleans hasn't been washed away in the hurricane). Then it's on to NYC. We'll be in NYC until November 11, after which it's back to the Golden West.

At New Orleans we'll probably see the biggest collection of gold bugs and hard money people ever assembled in one room (over 3,000 attendees). What will I tell them about gold? I'll tell them that it's all in this chart.

The accompanying daily chart traces gold from late-1984 to the present. The dotted line running through the gold price is a 144-day (exponential) moving average of gold. Note that gold has been clinging close to the moving average for the past seven months. At present, the London gold fix is just above the MA, and this is constructive.

The momentum indicator is an 89-day rate-of-change index. It is arrived at by dividing the price of gold daily by its price of 89 days ago. Right now gold is still holding above the 1.00 level, which means that gold is constructively above its price of 89 days ago. So gold continues to be in a very mildly bullish mode. The upside target for gold is the 340.90 peak of last August 28, as seen on the chart.

Meanwhile, gold and the precious metals are wearing out the patience of their fans. But they are not wearing out my patience. I continue to buy the coins. One month I buy some Kruggerands, the next month an equal amount of Maple Leafs, and the third month



some of the beautiful Chinese Pandas. For those who do not know, the Pandas came out in 1982. The Chinese government changes the design of the 1-ounce pure gold coins each year. And the price of the Pandas has been going up. The 1982 Pandas now sell for over $800.

LATE NOTES: On Friday (Nov. 1) my PTI climbed to a new high of 1940, thereby confirming the all-time Dow high of 1390.25 which was recorded on the same day. It now remains for the A-D ratio (see page 2 chart) and the major composite indices to catch up with the Dow and the PTI. One of the bullish phenomena here is that the odd lotters continue to short at amazingly high levels -- day after day. Thus, the "little fellow" is betting on a market collapse. As usual in such cases, his eagerness to short a confirmed bull market will cost him dearly. Bond action continues to be bullish for interest rates and the market.

NEXT MAILING: Nov. 20